Nepal's Economic Prospects and Challenges
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Nepal's current political situation is fragile. The country has been politically unstable since the end of the civil conflict in 2006. The first elected government collapsed in 2009, following which a new prime minister (Madhav Kumar Nepal) was elected and a new ruling coalition was formed. However, it is made up of 22 loosely connected political parties. A new constitution is scheduled to be drafted in May 2010 by the constituent assembly; this will require a degree of political consensus that many observers say will be difficult to achieve.

Antagonism between the army and the Unified Communist Party of Nepal (Maoist), or UCPM, is a major source of instability. The UCPM is the largest party in the constituent assembly and enjoys considerable political leverage. The UCPM was largely responsible for the collapse of the previous government over a disagreement with the president about removing the army chief. Since then, the UCPM has organized strikes almost daily.

Nepal has been enjoying comfortable rates of growth, but political instability blocks the economy's potential. Nepal's GDP grew at 5.3% in FY 2007/2008 (July 16th-July 15th) and 4.7% in FY 2008/2009. Growth in FY 2009/2010 is expected to be in the 4-5% range once more. However, strikes and political uncertainty constitute an obstacle to present and future economic activity. Strikes are estimated to cost businesses $7-14 million daily. They halt activities across the country in transport, government offices, private businesses, schools, hospitals and markets that increase perceived investment risk and create shortages by hindering the movement of goods and people. Lack of government cohesion hampers economic policy making, implementation and reforms.

Scarce rainfall during this monsoon season is a worrying sign for the economy. Agriculture accounts for over 30% of GDP and employs a vast majority of the population. Slower agricultural growth in FY 2008/2009 compared to FY 2007/2008 negatively affected GDP growth. As in other countries in the region, agriculture is heavily dependent on monsoon rains. Unfortunately, rains this past summer were late and scarce (one estimate shows only 66% of normal rainfall). In some areas they were torrential, however, with devastating impacts on crops and adverse effects on agricultural markets due to floods and landslides. Paradoxically, the importance of the agricultural sector in the economy has acted as a cushion against the impacts of the global downturn because of the sector's limited external integration.

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Inflation rose in FY 2008/2009. Inflation almost doubled (to 13%) in FY 2008/2009 due to higher commodity prices, broad money supply growth, and other inflationary pressures such as domestic market imperfections, flawed public service delivery systems and supply disruptions caused by strikes and protests. In addition the Indian Rupee, to which the Nepali Rupee is pegged, depreciated between September 2008 and April 2009, thus removing another barrier against inflation by making overseas goods costlier. The rise in food prices has played a significant role in increasing inflation rates, as they make up 53% of the CPI.

However, inflation should dramatically decrease in FY 2009/2010, with positive impacts on consumption. Commodity prices are set to decline in FY 2009/2010 and the Indian Rupee has been stable since April. Moreover, the Nepal Rastra Bank (NRB, the central bank) stated its intention to limit the growth of broad money supply in FY 2009/2010 and has set a target for its growth to 17% in 2009/10 (compared to an estimated 21% in 2008/09). The government expects inflation to decelerate to 7% in FY 2009/2010 in spite of continued domestic supply-side inflationary pressures. Falling consumer prices in FY 2009/2010 could have a positive impact on real consumption, which is the largest component of the economy on the expenditure side. Consumption is estimated to have accounted for 79.2% of GDP in FY 2008/2009.

The government's budget for FY 2009/2010 includes large spending increases. The budget for FY 2009/2010 plans for a 33.8% increase in total expenditure compared to FY 2008/2009. In large part because of the numerous ethnic-based parties and various demands in the legislature, the FY 2009/2010 budget has a strong populist orientation and the government is aiming for "socialism" and "people-oriented growth". As such, the new budget favors large spending increases in agriculture (including irrigation), road infrastructure, low-cost housing, hydroelectric generation and rural electrification, as well as specific earmarks for conflict victims, endangered ethnic groups and women. Business-oriented reforms are few although some taxes have been eliminated.

If the budget is spent according to plans, it will have the potential to reduce Nepal's poverty headcount, which stands at around 30%. Spending in rural areas and on agriculture (including irrigation to reduce the vulnerability to bad monsoons, electrification, and roads to facilitate market exchanges) will likely be instrumental in this respect, because a large portion of the poor live in rural areas and depend on agriculture for their livelihoods.

However, recently the government has underspent, in part due to socio-political disturbances but also because of low local administrative capacity and an unclear understanding of priorities. This is unlikely to change in FY 2009/2010, especially since the budget still lacks total endorsement by key political parties. As of November 16, 2009 the budget still had not yet been passed, mainly due to opposition by the UCPM. Although under-spending might be desirable from a fiscal viewpoint, it is likely to severely impede any poverty reduction gains that could be achieved through the implementation of the budget. On a positive note, remittances continue to be abundant; they have enabled a large proportion of the increased incomes and poverty reduction.

Public debt has been on a decreasing path but revenue collection, inconsistent financial management and fiscal losses deprive the government of important funds. Public debt remained on a decreasing path and within the boundaries of 40-50% of GDP in FY 2006/2007 and FY 2008/2009. However, several fiscal issues remain. Public financial management could be improved, notably in the areas of accounting, auditing and reporting of operations. Revenue collection has risen since the introduction of the Large Taxpayer Office, but could be raised substantially through customs modernization. Public enterprises, which are characterized by low transparency and accountability, absorb substantial amounts of public funds. In particular, the state oil company has been recording deficits of around 1½ to 2% of GDP. This is particularly worrisome since one-third of government spending occurs outside the budget framework, including spending on public enterprises. A positive development has been the inclusion in the FY 2009/2010 budget of a provision for a review commission to examine budget management practices.

Given the proposed FY 2009/2010 budget and the aforementioned institutional issues, maintaining fiscal discipline could prove challenging. However, achieving fiscal discipline will be crucial to keeping prices under control, which will also avoid a real appreciation of the Nepali Rupee. In addition, having comfortable cash reserves would ensure that potential revenue growth losses (including from public enterprises) can be absorbed.

The current account deficit in FY 2009/2010 should narrow due to the fall in commodity prices and continued remittance and tourism receipts. In FY 2008/2009 the trade deficit worsened in nominal terms due to global commodity and oil price increases. As these prices decline in FY 2009/2010, so should the trade deficit. Nepal’s current account benefits from high volumes of overseas remittances and high exposure to tourism, although in this respect the risks posed by the current political instability should not be underestimated. Nepal’s external position will largely depend on the economic prospects in countries employing its overseas workers and in countries that are important partners in the tourism sector, for which there is enormous potential.

Although India is Nepal’s largest trading partner, Nepal has been trying to expand its trading activities with Sri Lanka and Pakistan. In 2008 India accounted for 67% of Nepal’s exports and 59.4% of its imports, and in this respect the pegged exchange rate has supported Nepal’s integration to one of the world’s largest economies. However, meetings and exchanges during the summer of 2009 between Nepali and Sri Lankan officials as well as Nepali and Pakistani officials have indicated that there is strong willingness on all sides to expand cooperation on trade and other exchanges. Areas of cooperation discussed with Sri Lanka, for example, include trade, investment, civil aviation and tourism.

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